



2006 YEAR-END TAX REVIEW

As 2006 draws to a close, it is important to consider year-end tax issues and strategies as they apply to your overall financial situation. We suggest that you review all of the categories to see if any of them apply to you or a family member.

2006 Federal Budget Changes

- **The GST decreased** effective July 1, 2006 from 7% to 6%.
- The **capital gains inclusion** rate is reduced from 25% to nil on gifts of publicly listed securities to public charities and publicly listed securities acquired through employee stock option programs.
- **Decrease to taxation of eligible dividends** introduced by the Liberals in November 2005 was enacted. (Some, but not all, provinces have followed suit.)
- A **Canadian Employment Credit** of \$500, rising to \$1,000 as of January 1, 2007.
- The **pension income tax credit** doubled to \$2,000.
- The **Universal Child Care Benefit** of \$1,200 per year to parents with children under the age of 6.
- A \$500 non-refundable tax credit per child for fees paid for **enrollment in an eligible physical activity program** starting in 2007.
- A **public transit pass tax credit**.
- A **textbook tax credit** based on the student's eligibility for the existing education tax credit.
- **Scholarships or bursaries** excluded from income for students in programs qualifying for the education tax credit.
- The mineral exploration tax credit of 15% on **flow-through shares** extended through 2008.

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- Effective January 1, 2007, the \$300,000 small business limit up to which the lower small business tax rate applies is increased to \$400,000.

RRSPs and Other Tax-Deferred Plans

- When **transferring assets into an RRSP** or other tax-deferred plan, any gain on these assets will be taxable to you in the year of transfer. However, any losses cannot be claimed – *so if you wish to realize the losses, sell the assets first and transfer the cash.*
- If funds were withdrawn from an RRSP prior to 2005 under the **Home Buyer's Plan**, a repayment equal to 1/15 of the amount withdrawn must be made by **March 1, 2007**. Failure to do so will result in the repayment amount being included as income for 2006.
- The **maximum contribution limits** for tax-deferred plans for 2006 and 2007 are as follows:

Year	Registered Retirement Savings Plan (RRSP) Limit	Defined Contribution Registered Pension Plan (RPP) Limit	Deferred Profit Sharing Plan (DPSP) Limit
2006	\$18,000	\$19,000	\$9,500
2007	\$19,000	\$20,000	\$10,000

- Note that the final day to contribute to an **employer's RPP** is **December 31, 2006**. The final day for all regular 2006 **RRSP contributions** is **March 1, 2007**. This is also the final day to contribute to a surviving spouse's RRSP for a deduction on the deceased's final tax return.
- **If you turn 69 in 2006**, you must convert your **RRSP/LIRA** to a RRIF/LIF/LRIF before **December 31, 2006**. Note that the beneficiary designation for your RRSP/LIRA *does not* automatically transfer to your newly established RRIF/LIF/LRIF. If you want your spouse or someone else to be the specific beneficiary of your new account, this must be indicated on your application. If you have contribution room available, make your contribution prior to conversion. *Individuals turning 69 this year DO NOT have the extra 60 days after year-end to make a contribution to their own RRSP.*
- **If you have a spouse who is younger than you**, you can base the minimum withdrawals from your **RRIF/LIF/LRIF** on his/her age. Another benefit of a



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younger spouse is that you may contribute to their RRSP until the end of the year in which *they* turn 69, based on *your* RRSP limit.

Investments

- Finance Minister Jim Flaherty has proposed a “distribution tax” to income paid out by **income trusts** that will effectively equalize the tax treatment of income trust distributions and corporate dividends. The distribution tax will apply to all new trusts as of January 1, 2007. Existing trusts are exempt until January 1, 2011.
- The change to the taxation of “eligible” dividends may create some unexpected results. An investor receiving a \$100 dividend would include \$145 of “taxable” dividends in their income, pay income tax, and then claim a dividend tax credit. This should result in less tax payable. However, certain government benefits and credits are reduced based on “net” income, which includes “taxable” dividends, as opposed to the amount actually received. As a result, **an individual might need to repay government benefits based on income that they never received!** A couple of examples where this might apply include Old Age Security and the Canada Child Tax Benefit.
- If you have **non-registered GICs** maturing in **late 2006**, defer reinvesting the proceeds in a new GIC until January 2007. The interest on a GIC purchased in December 2006 will be taxable in 2007, while the interest on a GIC purchased in January 2007 will be taxable in 2008.
- If you invest in **non-registered mutual funds** (outside of your registered accounts) between now and **December 31**, you may be in for a shock when you file your 2006 income tax return. Mutual funds must distribute all interest, dividends and realized capital gains to unit holders in the fiscal year in which they receive them. Many Canadian funds use the calendar year as their fiscal year. A year-end distribution results in you paying tax on the distribution allocated to you, although you have not enjoyed the income.
- For those parents or grandparents who have **in trust accounts** for their children or grandchildren, capital gains can be purposely triggered now to avoid paying taxes in the future. Since minor children generally have no taxable income, they can effectively realize almost \$18,000 of gross capital gains and pay no tax as a result of their basic personal exemption. Realizing these gains now, while there are no tax consequences, will increase the adjusted cost base and decrease the taxable capital gains on future dispositions.
- The **deadline to contribute to an RESP** for 2006 is **December 31, 2006**. *You DO NOT have 60 days after the end of the year to contribute as with an RRSP.*



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Also unlike an RRSP, you may not carry forward unused contribution room to future years. The absolute maximum that you may contribute to an RESP in any year is \$4,000 per child. Any contribution room that is not utilized during the year would be lost forever.

- The **Canada Education Savings Grant (CESG)** is available on the first \$2,000 per year of RESP contributions made for a child who is under the age of 18. The amount of the grant is 20% of the amount contributed, for a maximum grant of \$400 per child per year. If you have not received the maximum CESG in previous years, you can apply for retroactive grants by contributing additional funds to the RESP in the current year. Keep in mind that you may not contribute more than \$4,000 per year to a child's RESP.

Capital Gains and Losses

- **The disposition of securities** is deemed to have taken place not on the day that the order is placed, but rather the 'settlement date'. For most securities, settlement occurs three days after placing a sell order. As such, to be considered on your 2006 tax return, Canadian transactions must be made by **December 22, 2006** and U.S. transactions must be made by **December 26, 2006**.
- 50% of your **capital gains** are included in your income. (Note the preferential treatment afforded charitable donations mentioned on page 1). **Capital losses** can be carried back and claimed against any capital gains reported in the previous three years (2003, 2004, or 2005) or carried forward indefinitely. *However, your current year losses must first be used to offset your current year gains (if any).*
- **Appreciation in the Canadian dollar** relative to the U.S. dollar may have created substantial foreign exchange issues in terms of capital gains or losses.
- Be aware of the **superficial loss rule**, which can negate the tax benefit of selling at a loss if you, your spouse or common law-partner, or another related entity acquires the same investment in the 30 days preceding *or* following the sale of the security on which you are claiming the loss. Note that an RRSP is considered to be a related entity.
- Employer **stock options** are taxed as employment income, *not* capital gains; hence, capital losses cannot be applied to reduce the tax payable.
- Be aware that you may trigger a deemed disposition or acquisition of assets even though no transaction occurs. Examples include a marriage break-up, entering or leaving Canada, RRSP contributions 'in kind', and 'change of use' of assets.



Borrowing for Tax Purposes

- As a general rule, interest is deductible for tax purposes as long as the loan is used for the purpose of earning income from a business or property. Often referred to as '**carrying charges**', several tax cases exist regarding the application of this rule. Other carrying charges include investment counseling fees, broker management costs, safety deposit box fees, etc. You should remit payments by the end of December if you wish to apply them to the 2006 tax year. There is draft legislation at the Federal level to limit the amount of interest deductible to the cumulative profit of the investment. Quebec has already changed its rules to provide similar limitations.
- For **spousal loans** established between **October 1, 2006** and **March 31, 2007**, the CRA prescribed interest rate is 5%.
- The deadline to pay **spousal loan interest** due in 2006 is **January 30, 2007**.

Charitable Donations

- Consider making a **charitable donation** of a security with an accrued capital gain instead of using cash. As a result of donating the security, *none of the gain* will be included as taxable income rather than the standard 50% inclusion. A tax receipt will be issued for the entire fair market value of the donated security, except for donations to private foundations. This special tax treatment is also available for shares acquired on the exercise of employee stock options if the shares are donated within 30 days of acquisition.
- Some charities allow the **donation of air miles or other loyalty program points**. Companies often make it difficult to redeem air miles and loyalty program points, which results in an accumulation of miles and points with little or no value. Donating these miles or points to charity is a great way to redeem them and make a difference at the same time. Depending on the organization, these donations can yield a tax receipt.

Employment-Related Issues

- **Stock options** give employees the right to purchase shares in their employer's company at a set price, known as the exercise price. The difference between the fair market value and this exercise price is taxed as employment income (*we emphasize - not capital gains*). Most employees can claim a deduction of 50% of



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the taxable benefit on qualified options, resulting in only 50% of the stock option benefit being taxed.

- Employees may be able to **defer taxation of stock option income** until the year the shares are actually sold. This deferral is subject to a limit of \$100,000 per year of vesting. **If you exercised any of your options in 2006 and continue to hold the stock on December 31**, you *must* notify your employer in writing by **January 15, 2007** in order to qualify for this deferral.
- **If you received a loan from your employer**, and you did not use the proceeds for the purpose of generating income, you can reduce the amount of the taxable benefit by making an interest payment before **January 30, 2007**.
- **If you have a company car**, there is a taxable benefit attributable to your use of the vehicle that is reported on your T4 and Relevé 1. Keep a log of your personal and business-use kilometres for your company vehicle to ensure easy reconciliation for your tax return. You may qualify for a reduced *standby charge* and *operating cost benefit* based on usage.
- **Employees who use their own car for business purposes** can receive a tax-exempt allowance from their employer if the allowance is based on the kilometers driven for business purposes, as opposed to a lump-sum allowance. The limit is 50 cents for the first 5,000 kilometres and 44 cents thereafter.
- **If you have eligible employment expenses or work from home more than half of the time**, your employer will be required to provide a form T2200, *Declaration of Employment Conditions*. Be sure you obtain a T2200 if it is applicable.
- **If you have tax-deductible expenses** such as RRSP contributions, support payments, childcare expenses, investment carrying charges, rental losses, etc., application can be made to the CRA or Revenu Québec to reduce your tax deductions at source for 2006. If approved, your employer may reduce the tax withheld at source resulting in increased cash flow. The approval process generally takes six weeks.

Income Tax Instalments

- If the difference between your **federal tax payable** and your income tax withheld at source is greater than \$2,000 (\$1,200 if you are a resident of Québec), you are generally asked to make **income tax instalment payments**. The reporting notices provided by the CRA can be confusing. If you expect that your liability will be more or less than previously calculated, you may want to adjust your final payment accordingly. While you do not want to overpay your tax, the CRA will



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charge you interest, and possibly penalties, if you underestimate the amount owing. The final federal income tax instalment for 2006 is due **December 15, 2006**, to the Receiver General of Canada.

- If the difference between your **Québec tax payable** and your Québec tax withheld at source is greater than \$1,200, you are generally asked to make instalments. The final Québec income tax instalment for 2006 is due **December 15, 2006**, to le Ministère du Revenu.

Alternative Minimum Tax

- Certain tax-deductible items may expose you to **Alternative Minimum Tax (AMT)**. While this tax may be carried forward and applied in future years, it can be lost if you leave Canada and have no further taxable Canadian income. Residents of Quebec can lose the provincial AMT simply by leaving the province.

Business Owners

- **For business owners** who employ family members, pay salaries by **December 31, 2006** to ensure earned income for RRSP and CPP/QPP contributions.
- **Owner managers** with control over their income may want to ensure that they have enough employment income to maximize their **RRSP contributions**. In order to reach the maximum contribution level for 2007 (\$19,000), you must have \$105,555 of earned income in 2006.
- **If purchasing capital assets** (such as computers, furniture or equipment) in the near future, consider making the purchase(s) before the calendar year-end, or fiscal year-end for businesses, as applicable. This will allow for a depreciation claim on your 2006 return.

Other Changes and Proposals

- On October 31, Finance Minister James Flaherty announced an **income splitting measure for pensioners**. Starting in 2007, a person receiving income that qualifies for the existing pension income tax credit may allocate up to 1/2 of that pension income to their spouse (or common-law partner). Eligible pension income includes payments from a registered pension plan (such as an employer's pension plan) and, for those aged 65 and over, RRIF payments and annuity payments from an RRSP. Further details are pending.



Québec Changes, Proposals and Differences

- Changes to **taxation in Québec** include:
 - a) **A new deduction for workers** beginning in 2006 recognizing work-related expenses used to earn income, subject to the greater of 6% of earned income or \$500.
 - b) A new premium to be levied on employment income, effective January 1, 2006, known as the **parental insurance plan**.
 - c) The \$300 deductible that previously applied to the refundable tax credit for **home support of elderly persons** has been abolished, effective January 1, 2007.
 - d) The **prescription drug insurance premium** will no longer apply to certain elderly taxpayers. Those who receive the maximum Old Age Security (OAS) pension and Guaranteed Income Supplement (GIS) pension will be exempt.
 - e) Québecers who buy or lease a **new hybrid vehicle** may be entitled to claim a partial refund of the Québec sales tax paid, to a \$1,000 maximum.
 - f) The **refundable tax credit for adoption expenses** has been increased. For 2006, the credit is equal to 30% of the actual adoption expenses to a maximum of \$6,000 per child
- The **stock option deduction** for Québec provincial tax purposes is 25%, compared to 50% for federal tax purposes.
- For **investors in Québec**, the amount of **deductible interest expense** is **limited** to the investment income earned in the taxation year. Exempt from this limitation are both rental income and active business income. These expenses can be carried back three years or carried forward indefinitely to apply against investment income.



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